

# Spending Policy

Excerpts of February 7 presentation to  
JFAC by the Endowment Fund  
Investment Board

*Prepared for:*

Board of Land Commissioners  
February 14, 2006



## Outline – Spending Policy

- Objectives that drive endowment management
- Structure of Idaho's endowment assets
- Endowment governance responsibilities
- Considerations in setting spending policy
- Determination of 2007 spending policy
- Improving endowment management

## **Goal of Most Endowments:**

Provide a perpetual stream of income

### **Success Criteria:**

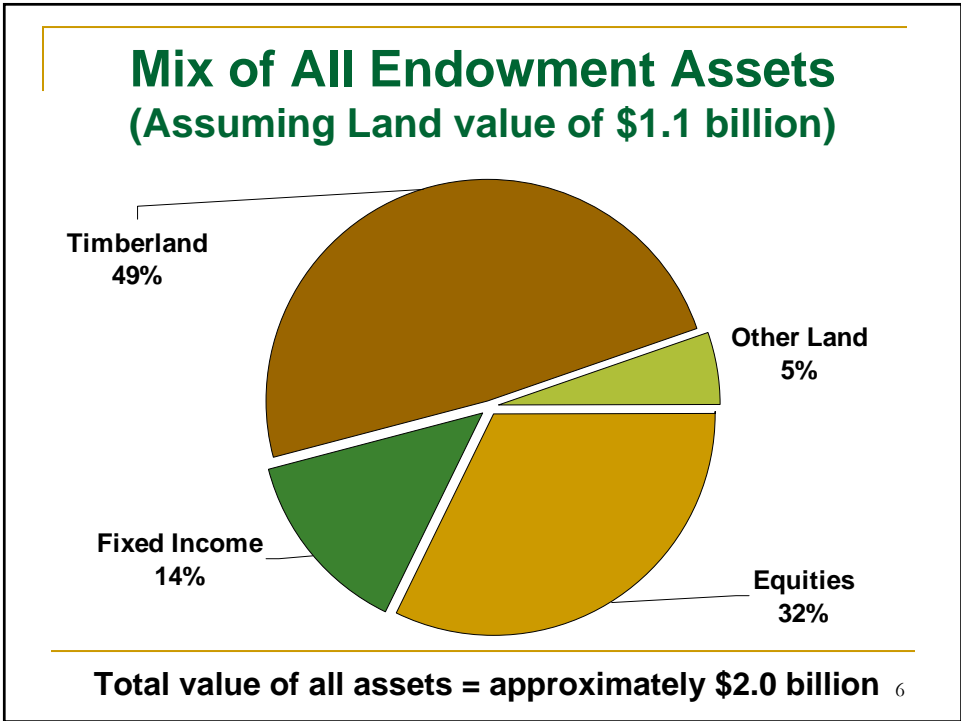
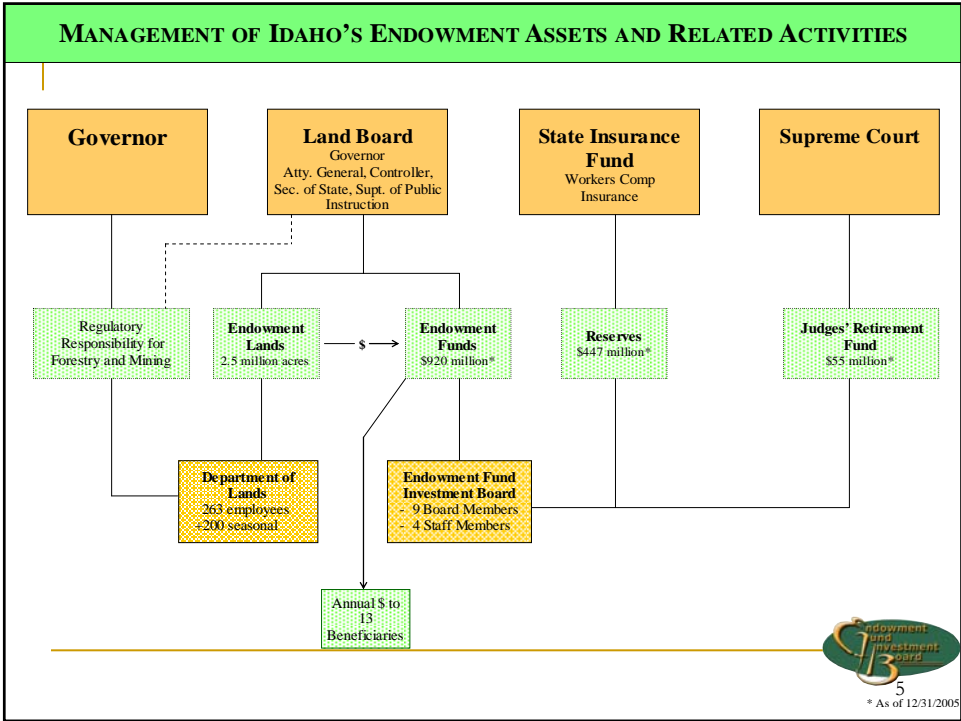
- Maximize total return over time at an acceptable level of risk
  - Optimize risk/return thru diversification
- Provide equitably for future generations
  - Maintain purchasing power of the income
- Hold distributions relatively stable
  - Support beneficiaries' ongoing needs

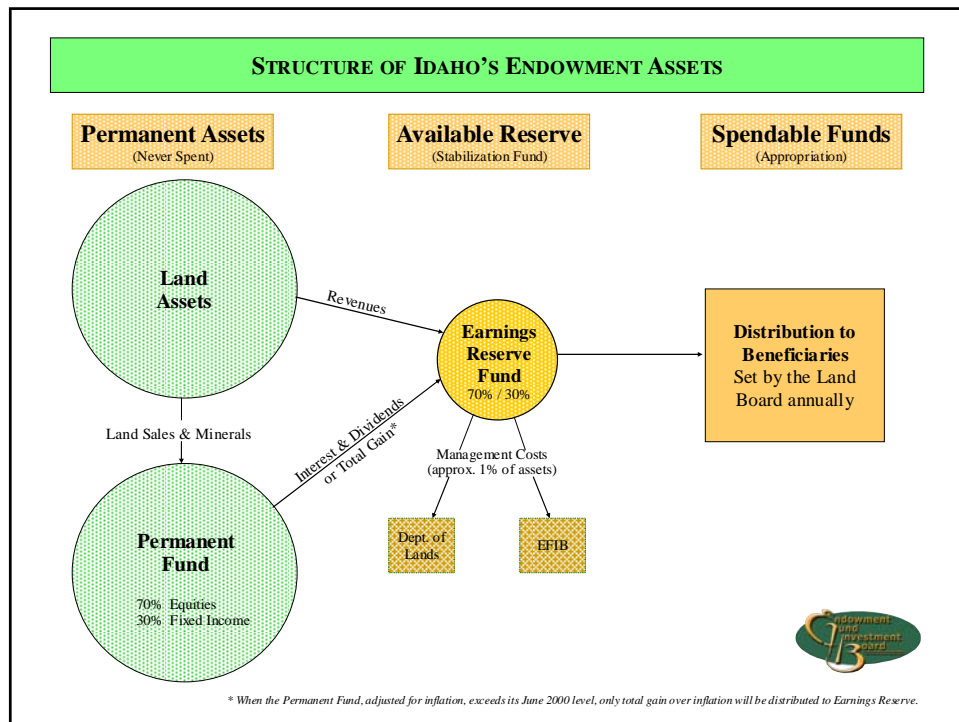
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## **Role in endowment governance**

- Land Board of Commissioners
- Endowment Fund Investment Board
- State Legislature

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## **Board of Land Commissioners Fiduciary duty**

- The constitution names the Board of Land Commissioners as the sole trustee of all endowment assets, both land and financial
- As trustee, they are fiduciaries and have responsibility under trust law to act in the best interest of the endowment beneficiaries in all their decisions

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## **Board of Land Commissioners Endowment responsibilities**

- Oversee land management activities of the Department of Lands
- Oversee investment activities of the Endowment Fund Investment Board
- Determine allocation of Earnings Reserve Funds
  - Distributed to beneficiaries (Spending Policy)
  - Retained for future distribution
  - Transferred to Permanent Fund to build corpus

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## **Endowment Fund Investment Board Endowment responsibilities**

- Determine investment policy
  - Asset mix
  - Allowed and prohibited investments
- Recommend allocation of Earnings Reserve (i.e. Spending Policy) to the Land Board
- Select and monitor investment mgrs.
- Select and direct staff

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## Idaho State Legislature Endowment responsibilities

- Legislate operating guidelines, including purchasing power protection and method of restoring losses to Public Schools fund
- Appropriate Earnings Reserve funds for operation of Dept. of Lands and Endowment Fund Investment Board
- Consider approved endowment distributions in setting beneficiary appropriations

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## Considerations in setting distributions

- Spendable funds can only come from earnings from the land or returns from the stocks and bonds
  - Permanent funds, adjusted for inflation, can never be spent
  - Changes in earnings must eventually impact spending
- Earnings Reserve fund must absorb volatility in:
  - Interest rates (return on fixed income)
  - Stock market returns (dividends and capital gains)
  - Revenues from state lands (variation in the rate of timber harvest and the price of timber)
- A balancing act: Every dollar in current year distributions increases the likelihood of a decrease in future distributions
  - **How much risk of a future shortfall do we want to take?**

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## Volatility of revenues and income

- From 2001 to 2006, net revenues to Earnings Reserve funds have averaged \$56 million/year, but varied plus/minus 15%, swinging up to \$17 million in one year
  - Smaller pooled endowments can experience swings of plus/minus 50%
  - Capital gains from equities vary widely
- All this volatility requires a “cushion” in Earnings Reserve (50% of permanent fund?)*

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## Forecasting 2007 Earnings Reserve balances – August 2005

- Beginning Earnings Reserve balance
- Interest and dividends forecast
  - Discounted 40% for potential drop in interest rates
- Lands revenue forecast
  - Discounted 5% in yr 1, 12% in year 2 for lower prices or slower harvest
- Management Expenses (1% of assets)

*Result: 2007 Earnings Reserve balance of \$77 million*

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## Fiscal Yr 2007 Distribution Summary

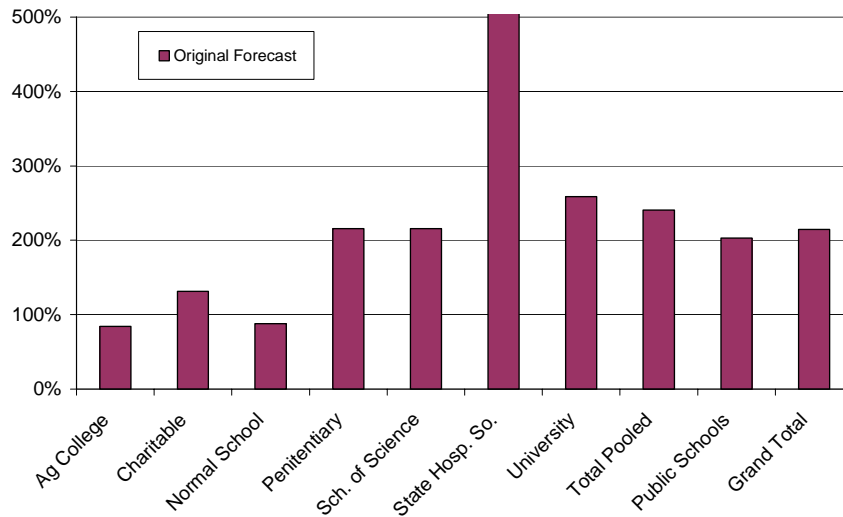
Endowment Beneficiary	FY 2007 Base	Line Items	FY 2007 Approv. Dist.	Change
All University Endowments	\$ 8,564,900	(\$ 959,900)	\$ 7,605,000	(11.2%)
State Juvenile Corrections	704,400	(74,700)	629,700	(10.6%)
Veterans Home	440,200	(46,600)	393,600	(10.6%)
School for the Deaf and Blind	88,000	(9,300)	78,700	(10.6%)
Penitentiary	926,900	(117,600)	809,300	(12.7%)
State Hospital North	704,400	(74,700)	629,700	(10.6%)
State Hospital South	1,227,000	(175,500)	1,051,500	(14.3%)
TOTAL Pooled Endowments	12,655,800	(1,458,300)	11,197,500	(11.5%)
Public Schools	23,087,100	1,561,100	24,648,200	6.8%
<b>Grand Total</b>	<b>35,742,900</b>	<b>102,800</b>	<b>35,845,700</b>	<b>0.3%</b>

### Measuring risk of shortfalls: Distribution coverage ratio

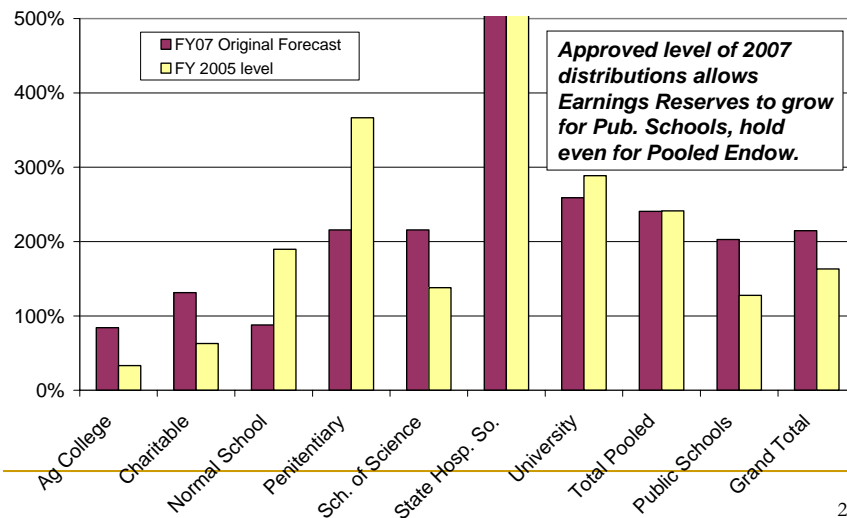
- The risk of shortfall in distributions was measured by comparing the Earnings Reserve balance at the end of fiscal 2007 with the amount of distributions
- This ratio measures the degree of reserve to maintain the distribution into future years

$$\frac{\text{Balance in Reserves}}{\text{Annual Distribution}}$$

## August 2005 Original Forecast: June 2007 Earnings Reserve Balances as % of Distribution



## 2005 vs. 2007 Forecast Earnings Reserve Balances as % of '07 Distribution



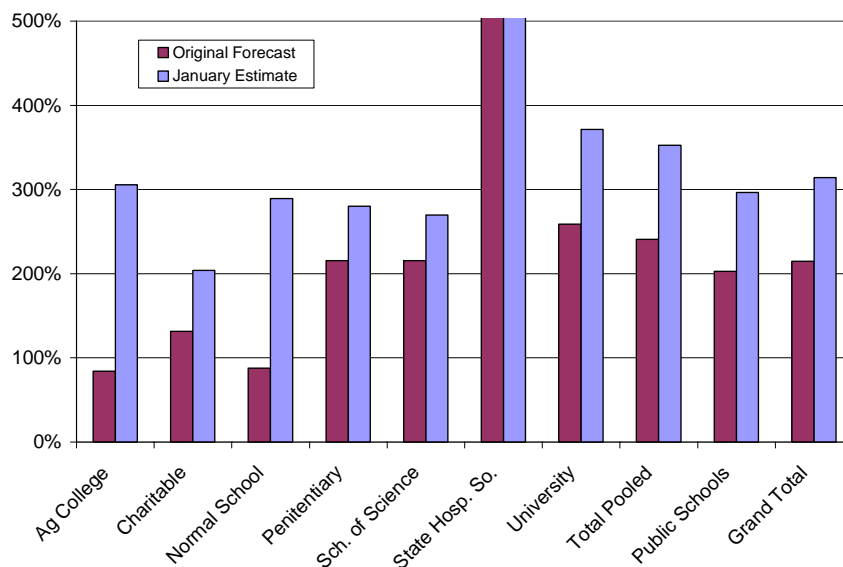
## January 2006 Update

Earnings Reserve up \$35 million at end of 2007 to \$112 million (300% of distributions)

- Lands revenues \$2 mill. over August forecast
- 2006 beginning balance \$8 million higher due to final audit adjustments
- Interest and dividends \$8 million above forecast in 2006 and 2007 (\$16 million total)
- \$9 million dedicated fund transfer requested

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### January 2006 Update: June 2007 Earnings Reserve Balances as % of Distribution



## **Risk of shortfalls in 2006 and 2007 (Based on January revised estimate)**

- Today's level of Earnings Reserve funds essentially ensure that appropriated fiscal 2006 and approved fiscal 2007 distributions can be made for all endowments
- June 2006 balances = at least 100% of 2007 distributions for all endowments
- June 2007 balances = at least 200% of 2007 distributions for all endowments

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## **Lots of unanswered questions re: endowment management**

- Is the current spending rule reasonable?
- Can we increase payouts in 2008 without jeopardizing future distributions?
- When will we return to the 2002 level of distributions?
- What criteria should be used to buy/sell endowment land?

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